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Hard Brexit: an insight on derivatives

Last Monday night 8 April 2019, also the Commons approved the bill forcing the premier Theresa May to **delay Brexit** beyond the next 12 April, date when the *hard Brexit* should be triggered, i.e. the withdrawal of the United Kingdom from the European Union without an agreement.

Looking forward to the forthcoming political developments, although at the moment the *hard Brexit* seems unlikely, given the importance of derivatives with UK counterparties also in relation to financing agreements governed by Italian law, we deem appropriate to analyse the emergency **instruments** adopted by the EU and by the national authority concerning derivatives in a hard Brexit scenario.

In the event of a no-deal Brexit, the English banks, as well as the UK central counterparties for derivatives, will lose their European passport and the consequent right to provide financial services in favour of entities resident in the other Member States.

This circumstance would jeopardise the operational continuity in various sectors of the financial markets, including derivatives. It is enough to recall that only the ICE Clear Europe, one of the three UK central counterparties, has positions in credit default swap for about 1,600 billion of dollars.

In order to avoid such risk, **the European Union**, on the one hand, **and the Member States** on the other hand, **have introduced certain measures**, based on the temporary principle of equivalence and aimed at allowing the European companies to continue trading with the English counterparties for a transition period, avoiding the issues related to the early termination of several derivative contracts. Such measures shall apply only if a withdrawal agreement is not reached pursuant to art. 50, paragraph 2, of the Treaty on European Union.



In order to identify the applicable interim regime, it is necessary to distinguish **the standard derivatives entered into with central counterparties** (i.e. the intervening guarantor institutions if one of the parties of the derivative is declared bankrupt) from **the uncleared derivatives**, those without a central counterparty and tailored with reference to each company. The interim regime for standard derivatives is issued directly by the European Union while the interim regime for uncleared derivatives is governed by domestic rules.

Starting from the EU rules, on 19 December 2018 the European Commission adopted certain emergency measures applicable in case of hard Brexit. Among these, we highlight the temporary and conditional equivalence decision for 12 months to ensure that there will be no disruption in central clearing of derivatives. In this respect, on 17 February 2019, the ESMA (European Securities and Markets Authority) announced that **the three central counterparties currently established in the United Kingdom** (ICE Clear Europe, LCH Limited and LME Clear Limited) **will benefit of temporary licenses to continue to operate on derivatives with European Union banks**.

Furthermore, pursuant to two delegated regulations, the Commission provided for a facilitating novation, for a fixed period, of **over-the-counter derivatives** contracts with a counterparty established in the United Kingdom to replace that counterparty with a counterparty established in the Union. The transfer of such contracts in favour of an EU counterparty will take place maintaining the exempted

status, i.e. by way of derogation to the reporting requirements set out under article 9 of Regulation (EU) no. 648/2012 (EMIR), which would not be applicable to the British central counterparties following an eventual hard Brexit.

Coming now to the national legislation, the Italian Legislative Decree no. 22 of 25 March 2019 (**Brexit Decree**) governed, *inter alia*, **the OTC derivatives existing on the withdrawal date and not eligible for central clearing**. Specifically, subject to notification in favour of the competent authorities, UK banks and UK investment firms operating under the regime of the freedom to provide services provisions will be able to negotiate only with eligible counterparties and professional clients (as identified under art. 6, paragraph 2-*quinquies*, let. a), and paragraph 2-*sexies*, let. a) of the Italian Finance Act) and exclusively for the management of "life cycle events" (including the amendment and the perfection of new contracts) of the uncleared derivatives.

With regard to **the UK banks and UK investment firms operating through Italian branches**, the Brexit Decree allow them to continue to carry out the same activities (only for the transition period and subject to notification in favour of the competent authorities) without specifying additional restrictions.

All the British institutions (both those operating under the freedom to provide services regime or those acting through Italian branches) that, after the transition period, intend to conduct business in Italy, shall submit a specific authorization **within 6 months** starting from the transition period (art. 3, paragraph 7, of Brexit Decree).

Lastly, by way of derogation from the above deadline, pursuant to art. 4, paragraph 4, of Brexit Decree, the UK banks and UK investment firms will be able to carry on the management of the life cycle events of OTC derivatives existing on the withdrawal date and not eligible for central clearing, even in the event of failure to notify the competent authorities or failure to submit the authorization provided under art. 3, paragraph 7, of Brexit Decree, for a limited period of time, respectively, of 6 months from the withdrawal date or 6 months from the expiry of the term for submission of the authorization.

The abovementioned measures **aim to safeguard the financial stability of the European Union**, mitigating risks in a sector in which individual measures adopted by market operators would be insufficient.

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